

# QUANTIFIABLE EDGES SUBSCRIBER LETTER

ASSESSING MARKET ACTION WITH INDICATORS AND HISTORY

August 4, 2008

Issue 116

## Market Overview

*Summary of Recent Active Studies (see <http://QuantifiableEdges.blogspot.com> or Letters from listed dates for details)*

Study Date	Description	Time span	Bias
August 4, 2008	Gap and rev lower employmt day	1 day	Bullish
July 31, 2008	Strong move on rising volume	1-10 days	Bullish
July 30, 2008	Big up after big down	1-12 days	Bullish
July 29, 2008	Down 1.5% lowest vol in10days	1-12 days	Bullish
July 29, 2008	Down 1.5% 2 of 3 - no 10day low	1-10 days	Bullish
July 28, 2008	P/C 40-day low, SPX < 0.5 rise	1-20 days	Bearish
July 25, 2008	Down big after bounce from lows	1-8 days	Bearish
July 18, 2008	Big Volume Big Gain Under 200	1-18 days	Bullish
July 18, 2008	2% then 1% gains under the 200	1-19 days	Bullish
July 7, 2008	5 Weeks Lower	1-10 weeks	Bearish
March 17, 2008	Consumer Sentiment Stretch	1-12 months	Bullish

### *Short-term Outlook (1-5 days) –somewhat bullish – updated 8/4*

The market fell for the 2<sup>nd</sup> day in a row on Friday, leaving the S&P 500 and Nasdaq just barely above where they began the week. Volume came in lower, which is preferable. Volume continues to perform well, falling on days the market falls and rising on days the market rises. Breadth was slightly to the downside. Decliners barely edged out advancers and downside volume made up about 56% of total volume. For the most part Friday appeared to be a tame pullback.

On Friday morning the employment data seemed to spark some optimism among traders. Futures quickly spiked higher after the release. While a good portion of the gain evaporated by the open, the market still managed to gap up. The gap up was used as an opportunity to sell, though as the market ended lower than the previous day's close.

Employment reports have the ability to consistently move the market as much as or more than any other economic report. I decided to look back and see how the market has performed following other times where the market gapped up the morning of an employment report but failed to hold onto its gains and closed lower on the day. Using SPY as a proxy I looked back to 1993. Results below:

<b>SPY gaps up morning of employment report but closes down on day. Buy on close. Sell X days later. \$100k/trade. 1993-present.</b>										
X Days	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Avg Trade	Profit Factor
10	\$27,074.49	26	17	9	65.38	\$2,601.73	(\$1,906.10)	1.36	\$1,041.33	2.58
9	\$31,215.25	26	19	7	73.08	\$2,280.33	(\$1,730.13)	1.32	\$1,200.59	3.58
8	\$30,313.88	26	18	8	69.23	\$2,246.98	(\$1,266.48)	1.77	\$1,165.92	3.99
7	\$34,707.98	26	18	8	69.23	\$2,527.61	(\$1,348.63)	1.87	\$1,334.92	4.22
6	\$28,033.05	26	16	10	61.54	\$2,372.52	(\$992.72)	2.39	\$1,078.19	3.82
5	\$14,775.11	26	15	11	57.69	\$1,651.06	(\$908.25)	1.82	\$568.27	2.48
4	\$11,866.97	26	16	10	61.54	\$1,336.82	(\$952.22)	1.40	\$456.42	2.25
3	\$5,905.34	26	17	9	65.38	\$1,057.95	(\$1,342.21)	0.79	\$227.13	1.49
2	\$7,451.95	26	13	13	50.00	\$1,210.92	(\$637.70)	1.90	\$286.61	1.90
1	\$10,506.51	26	20	6	76.92	\$758.99	(\$778.89)	0.97	\$404.10	3.25

A bit of an upside edge has been prevalent over the next 2 weeks following these kinds of “employment day reversals lower”. Most of the edge occurred on day 1, where you’ll find the largest percentage of wins and about 40% of the total gains. Using the [t-table from the significance post](#) in the blog, you’ll notice that there is about 99% confidence of some kind of an upside edge for Monday.

Below is tonight’s [Aggregator](#) chart:



The green Aggregator line is basically neutral while the black differential line shows slight underperformance by the S&P over the last 3 days. This would normally suggest no edge provided by the aggregate of the studies. Two things should be pointed out, though, that are not immediately obvious. First, July 30<sup>th</sup> will be dropped from the differential line tomorrow. Therefore a breakeven day would move the black differential line up nearly 0.5%. Also the green Aggregator line will be dropping some very weak readings and adding some very strong ones over the next couple of days. Therefore, there is a good chance we will see both lines head higher in the next day or so. This would imply that weakness early in the week could be buyable for a swing trade.

**Intermediate-term Outlook (1 week – 2 months) -neutral – updated 8/4**

The intermediate-term outlook has a few positives right now, but now a whole lot. The fact that breadth and sentiment had become so extremely negative prior to the mid-July bottom is something that is frequently seen near important bottoms. I showed a study which looked at bounces after extreme breadth readings in the July 20<sup>th</sup> Letter. I have included a copy of this study in the addendum below.

The [consumer sentiment study](#) from March is still active and shows a positive bias as well. Additionally, I like [the volume pattern](#) that the market has exhibited recently.

There are concerns, though. The relatively low put/call ratio which I discussed [last week](#) remains low, suggesting complacency among option traders. The persistence shown during the selloff in June and early July is something that is not normally quickly overcome as discussed in the [July 7<sup>th</sup> study](#).

The “original rule” Follow Through Day (FTD) from July 22 has so far failed to ignite a further rally. [My findings have shown](#) that the first week after a FTD tends to be fairly predictive of whether the FTD will succeed or fail. There have been eight trading days since the FTD. The only days where the S&P closed above the close of the FTD were days 1 and 6. This would suggest about a 67% chance of failure for the signal, which would entail a trip below the July lows.

The fact that the past week saw a relatively wide range with a small relative percent change at the close has tended to have bearish implications when a long-term downtrend has been present.

Below I show how the market has performed the next week after a relatively large range closed varying levels of change from the week before:

SPX trades in > 2.5% range and closes within X% of last week's close. Also closes < 40 week MA.										
Buy on close. Sell 1 week later. \$100k/trade. 1960-present.										
X% Change	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Avg Trade	Profit Factor
1	(\$1,208.28)	86	42	44	48.84	\$2,163.95	(\$2,093.05)	1.03	(\$14.05)	0.99
0.75	(\$9,456.60)	60	30	30	50.00	\$2,198.22	(\$2,513.44)	0.87	(\$157.61)	0.87
0.5	(\$3,044.96)	36	17	19	47.22	\$2,608.62	(\$2,494.29)	1.05	(\$84.58)	0.94
0.25	(\$16,069.95)	17	6	11	35.29	\$2,671.88	(\$2,918.29)	0.92	(\$945.29)	0.50

As you can see above the very tight closing change of 0.25% or less has severely underperformed larger % increases or decreases.

To see what affect the range portion of the equation has on results I looked at varying ranges. In this case I held the position for 5 weeks.

S&P has range > X% and change < 0.25% on the week. Close < 40wk ma. Buy on close. Sell 5 weeks later. \$100k/trade. 1960 -										
X Range	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Avg Trade	Profit Factor
3.5	(\$15,423.33)	3	1	2	33.33	\$1,768.00	(\$8,595.67)	0.21	(\$5,141.11)	0.10
3	(\$17,772.44)	7	2	5	28.57	\$3,558.53	(\$4,977.90)	0.71	(\$2,538.92)	0.29
2.5	(\$24,572.95)	14	5	9	35.71	\$3,273.67	(\$4,549.04)	0.72	(\$1,755.21)	0.40
2	\$9,502.56	23	12	11	52.17	\$4,178.26	(\$3,694.24)	1.13	\$413.15	1.23
1.5	\$34,301.38	30	18	12	60.00	\$4,755.94	(\$4,275.46)	1.11	\$1,143.38	1.67
1	\$26,573.82	36	21	15	58.33	\$4,024.92	(\$3,863.30)	1.04	\$738.16	1.46
0.5	\$30,026.93	41	23	18	56.10	\$4,170.07	(\$3,660.26)	1.14	\$732.36	1.46
0	\$27,751.03	43	24	19	55.81	\$4,044.90	(\$3,648.76)	1.11	\$645.37	1.40

Here we can see that the wider ranges clearly underperform the tighter ranges when look at a small percent change on the week.

So using a 2.5% or greater range and a net change of less than 0.25% and looking out over the next 1-5 weeks I get the following results:

SPX range > 2.5% and net change < 0.25%. Close < 40 week MA. Buy SPX on close. Sell X Weeks later. \$100k/trade. 1960 -										
X Weeks	Net Profit	Trades	Wins	Losses	% Wins	Avg Win	Avg Loss	W/L Ratio	Avg Trade	Profit Factor
5	(\$24,572.95)	14	5	9	35.71	\$3,273.67	(\$4,549.04)	0.72	(\$1,755.21)	0.40
4	(\$39,054.28)	14	4	10	28.57	\$3,031.28	(\$5,117.94)	0.59	(\$2,789.59)	0.24
3	(\$25,944.94)	15	6	9	40.00	\$4,767.05	(\$6,060.80)	0.79	(\$1,729.66)	0.52
2	(\$23,594.20)	15	5	10	33.33	\$4,668.24	(\$4,693.54)	0.99	(\$1,572.95)	0.50
1	(\$16,069.95)	17	6	11	35.29	\$2,671.88	(\$2,918.29)	0.92	(\$945.29)	0.50

While the results may not be statistically significant due to the low number of instances, the negative bias in terms of wins to losses and average trade is notable nonetheless.

My intermediate-term outlook remains very similar to last week. While I believe the market will be higher and likely in the midst of a substantial rally 3-4 months from now, 3-4 weeks from now remains murky. Stronger breadth would go a long way toward making me more comfortable. Right now I'm taking things little by little and constantly re-evaluating.

### **Addendum – July 20<sup>th</sup> Oversold Breadth Bounce**

One metric that suggests an intermediate-term edge to the upside is the fact that breadth had become so extremely negative. Normally breadth measures as bad as we recently saw signify the market has been washed out to the point that an intermediate-term rally is likely to have either begun or is soon to begin. An example is the [Net New Lows study](#) I showed in the blog on Wednesday. Taking oversold net new low conditions like we saw last week and combining that with a bounce of at least 5% over the next 2 days from low to high I devised the following study:

NYSE (New lows - new highs) / Totals Issues > 33% two days ago. SP-500 jumps over 5% from low of 2 days ago. Buy on close. Sell X Days later. \$100,000 per trade. 1970 - present										
X Days	Net Profit	Trades	Wins	Max Win	Max Loss	Avg Win	Avg Loss	W/L Ratio	Avg Trade	Profit Factor
200	\$126,785.17	5	5	\$39,771.20	\$0.00	\$25,357.03	\$0.00	100.00	\$25,357.03	100.00
120	\$84,134.33	5	5	\$26,589.64	\$0.00	\$16,826.87	\$0.00	100.00	\$16,826.87	100.00
100	\$57,372.77	5	5	\$22,879.23	\$0.00	\$11,474.55	\$0.00	100.00	\$11,474.55	100.00
80	\$40,115.13	5	5	\$19,286.30	\$0.00	\$8,023.03	\$0.00	100.00	\$8,023.03	100.00
40	\$14,612.71	5	3	\$9,760.63	(\$5,959.80)	\$7,798.80	(\$4,391.84)	1.78	\$2,922.54	2.66
20	(\$138.92)	5	2	\$6,025.04	(\$4,965.21)	\$4,857.94	(\$3,284.93)	1.48	(\$27.78)	0.99

Over the next month there is mixed results, but the longer you go out the stronger they get. While the number of instances is too low for accurate estimation, the results are impressive – an average return of nearly 17% over the next 6 months and 25% over the next 200 days. While in all cases an intermediate-term low was near, it wasn't always already established. Below are all the results of a 120-day (about 6 month) holding period, along with some notes on each occurrence.

<b>(New lows - new highs) / Totals Issues &gt; 33% two days ago.</b>				
<b>Market jumps over 5% from low of 2 days ago.</b>				
<b>Buy on close. Sell 120 trading days later. 1970 - present.</b>				
<b>Date</b>	<b>Signal</b>	<b>Price</b>	<b>% Profit</b>	<b>Note</b>
5/28/1970	Buy	\$74.61	11.57%	<b>Low never tested.</b>
11/16/1970	Sell	\$83.24		
9/17/1974	Buy	\$67.38	26.08%	Low undercut by about 5% 2-3 weeks
3/10/1975	Sell	\$84.95		later before rally took off.
3/31/1980	Buy	\$102.09	26.60%	<b>Low never tested.</b>
9/19/1980	Sell	\$129.25		
10/21/1987	Buy	\$258.38	5.10%	<b>Low was tested but not undercut</b>
4/13/1988	Sell	\$271.55		<b>1 1/2 months later.</b>
8/27/1990	Buy	\$321.44	14.81%	Low was undercut by 4% a couple of times
2/15/1991	Sell	\$369.06		over the next 2 months before rally stuck.

### **Catapult and Capitulative Breadth Statistics**

*(Catapult Presentation Part 1) (Catapult Presentation Part 2)*

#### **Open Catapult Trades**

none

#### **Open Big 50 Trades**

None

#### **Catapult for ETF's Trades**

none

#### **Broad Market Large Cap CBI – 0**

#### **Sector CBI Breakdown (% of stocks with active catapult triggers within each sector.)**

<b>Index</b>	<b>ETF</b>	<b>CBI %</b>	<b>Index</b>	<b>ETF</b>	<b>CBI %</b>
DJ US Broker Dealers	IAI	0.00	DJ US Energy	IYE	1.16
DJ US Insurance Index	IAK	0.00	DJ US Financial	IYF	0.00
DJ US Regional Banks	IAT	0.00	DJ US Financial Services	IYG	0.00
DJ US Utilities	IDU	2.70	DJ US Healthcare	IYH	0.70
DJ US Oil&Gas Expl & Prod	IEO	3.45	DJ US Industrial Sector	IYJ	1.15
DJ US Oil Equip & Svcs	IEZ	1.92	DJ US Consumer Goods	IYK	0.00
DJ US Pharmaceuticals	IHE	0.00	DJ US Basic Materials	IYM	1.35
DJ US Healthcare Providers	IHF	0.00	DJ US Real Estate	IYR	0.00
DJ US Medical Devices	IHI	0.00	DJ US Transportation	IYT	0.00
DJ US Aerospace & Defense	ITA	0.00	DJ US Technology Sector	IYW	2.01
DJ US Home Construction	ITB	0.00	DJ US Telecommunications	IYZ	0.00
DJ US Consumer Svcs	IYC	0.44	Nasdaq 100	QQQQ	2.00

### **Additional New Trade Ideas**

*SPY* – buy ¼ of full position at \$125.50. Based on the short-term outlook and tonight's employment day reversal study I'd like to buy weakness in the morning. Should it not get filled before noon, I may send out an intraday update canceling the trade idea.

### **Active Trades Table**

<b>Symbol</b>	<b>Entry Date</b>	<b>Entry Price</b>	<b>Current Price</b>	<b>% Gain/Loss</b>	<b>Stop</b>	<b>Notes</b>
UNG	7/22/2008	\$47.57	\$43.81	-7.90%	\$41.00	sell on close > 10ma
RSX	7/25/2008	\$44.62	\$44.74	0.27%	\$42.79	sell on close > 10ma

### **Stocks and ETF's on my Radar**

BA – made new low and reversed to close about 1.5% higher. Possible bounce candidate.

BBH – Sharp drop on Friday. Strong uptrend. Could be pullback candidate in next day or two.

### **Notable S&P 500 stocks outside my “tradable” radar**

*None*

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